Nos. 667-670

DEC 15

CHARLES ELMORE

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

WESLEY W. WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

J. MARION WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

ESTATE OF J. M. WEST, DECEASED,
JAMES M. WEST, JR., ET AL., EXECUTORS, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

JESSIE GERTRUDE WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT AND BRIEF IN SUPPORT THEREOF.

RANDOLPH E. PAUL,
J. ARTHUR PLATT,
JAMES H. YEATMAN,
Counsel for the Petitioners.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

INDEX

	Page
OPINIONS BELOW	2
JURISDICTION	2
QUESTIONS PRESENTED	2
STATUTE INVOLVED	3
STATEMENT OF FACTS	4
SPECIFICATION OF ERRORS TO BE URGED	6
REASONS FOR GRANTING THE WRIT	7
POINT I. The question involved is an important question of federal law which has not been, but should be, decided by this Court	7
POINT II. The decision of the Circuit Court of Appeals is in conflict with the principles laid down by this Court in related cases	8
POINT III. The decision of the Circuit Court is in conflict with principles laid down by the Ninth Circuit in related cases	9
POINT IV. The Circuit Court's decision is in conflict with this Court's decision in Trust u/w of Mary Lily (Flagler) Bingham v. Commissioner	12
CONCLUSION	13

CITATIONS

Page

CASES:

Anderson v. Helvering, 310 U. S. 404 ..... 8, 9
Burnet v. Harmel, 287 U. S. 103 ..... 8, 9, 12
Commissioner v. Crawford, 148 F. (2d) 776 ..... 9, 10
Commissioner v. Felix Oil Co., 144 F. (2d) 276 ..... 9, 10
Commissioner v. Kirby Petroleum Co., 148 F. (2d) 80 ..... 10, 11
Dobson v. Commissioner, 320 U. S. 489, rehearing denied, 321 U. S. 231 12
Fairbanks v. United States, 306 U. S. 436 12
Powers v. Commissioner, 312 U. S. 259 12
Helvering v. Elbe Oil Land Development Co., 303 U. S. 372 ..... 8, 9
Herring v. Commissioner, 293 U. S. 322 ..... 8, 9
Palmer v. Bender, 287 U. S. 551 ..... 8, 9
Thomas v. Perkins, 301 U. S. 655 8
Trust u/w of Bingham v. Commissioner, 65 S. Ct. 1232 12

STATUTES:

Revenue Act of 1938, c. 289, 52 Stat. 447; Sec. 117 .. 3

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

WESLEY W. WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

J. MARION WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

ESTATE OF J. M. WEST, DECEASED,
JAMES M. WEST, JR., ET AL., EXECUTORS, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

JESSIE GERTRUDE WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

The Petitioners, Wesley W. West, J. Marion West, Estate of J. M. West, Deceased, James M. West, Jr., et al., Executors, and Jessie Gertrude West,[1] pray that a writ of

[1] The proceedings involving the above entitled petitioners were consolidated with that of Wesley W. West in the Tax Court (R. 20), in the Circuit Court of Appeals (R. 324) and in this Court (R. 356) and only one record has been printed covering the consolidated cases *sub nom. Wesley W. West* v. *Commissioner of Internal Revenue*.

certiorari be issued to review the decision of the Circuit Court of Appeals for the Fifth Circuit in the above case.

OPINIONS BELOW.

The opinion of the Tax Court of the United States (R. 236 to 281) is reported in 3 T. C. 431. The opinion of the Circuit Court of Appeals for the Fifth Circuit (R. 331 to 344) is reported in 150 F. (2d) 723.

JURISDICTION.

The judgments of the Circuit Court of Appeals were entered on July 24, 1945. (R. 344). An order was promulgated by the Circuit Court of Appeals dated Aug. 3, 1945 (R. 348) granting an extension of time for filling a petition for rehearing until September 11, 1945. Pursuant to this order, the petitioners filed a petition for rehearing (R. 349) on September 8, 1945. The petition for rehearing was denied by the Circuit Court of Appeals by an order dated September 18, 1945. (R. 353, 354) The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925, c. 229, 43 Stat. 936, Title 28 U. S. C. § 347.

QUESTIONS PRESENTED.

1. Whether the conveyance of the petitioners' lands under a general warranty deed and contract of December 28, 1938, including portions of the minerals thereunder constituted a sale of capital assets within the meaning of Section 117 of the Revenue Act of 1938, or whether the transaction was a sale of the surface of the land and the mere leasing of the minerals.

2. Whether the Tax Court's conclusion concerning the legal effect of the transaction and its interpretation and application of Section 117 of the Revenue Act of 1938 is final and binding upon review.

STATUTE INVOLVED.

The Statute involved is Section 117 of the Revenue Act of 1938, c. 289, 52 Stat. 447.

"Sec. 117. CAPITAL GAINS AND LOSSES.

(a) DEFINITIONS.—As used in this title—

* * * * *

(4) LONG-TERM CAPITAL GAIN.—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income;

* * * * *

(b) PERCENTAGE TAKEN INTO ACCOUNT.—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income;

* * * * *

50 per centum if the capital asset has been held for more than 24 months.

(c) ALTERNATIVE TAXES.—

(1) IN CASE OF NET LONG-TERM CAPITAL GAIN.—If for any taxable year a taxpayer (other than a corporation) derives a net long-term capital gain, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 11 and 12, a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

A partial tax shall first be computed upon the net income reduced by the amount of the net long-term capital gain, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be the partial tax plus 30 per centum of the net long-term capital gain."

STATEMENT OF FACTS.

Deficiencies[2] of income tax were asserted against the petitioners for the tax year 1938. They arose out of a transaction in which on December 28, 1938, petitioners, for a cash consideration,[3] conveyed to Humble Oil & Refining Company, herein called "Humble," by general warranty deed the fee simple title to certain lands and minerals they had owned for more than two years.[4] The property conveyed comprised: (1) the 200 acre homestead tract of J. M. West and Jessie Gertrude West, together with a portion of the minerals thereunder, in which the other petitioners had no interest; (2) 22,955.60 acres of other land and a portion of the minerals thereunder; and (3) a portion of the minerals only in 70.67 additional acres of land. (R. 239). There was one producing oil well, one producing gas well and one well being drilled by petitioners at the time of the consummation of the sale. (R. 256). The petitioners did not convey all of the minerals in the lands but excepted from the conveyance

---

[2] The amounts were as follows:

Wesley W. West	$713,494.14
J. Marion West	727,191.99
Estate of J. M. West	371,978.10
Jessie Gertrude West	371,978.10

(R. 237)

Upon computation under Rule 50 of the Tax Court the deficiency of Wesley W. West was found to be $642,711.97 (R. 310) by reason of certain adjustments not now in issue. No similar computation for the other petitioners is contained in the record.

[3] The cash payment was $8,032,145.26 (R. 257) and included payments to the charitable foundation and a payment of $65,000 (R. 257) for the assignment of two leases (covering minerals in other lands) which are not here in question. Certain improvements including oil improvements upon the land were also conveyed (R. 238). There is here no controversy concerning the tax treatment of the improvements as such.

[4] J. M. West was then alive and a charitable foundation not here involved was also a grantor. For purposes of convenience, however, the grantors will be referred to as the petitioners.

and kept for themselves a fractional interest in the minerals.[5]

Contemporaneously with the execution of the deed, the petitioners executed a contract (R. 238) with Humble in which Humble assumed certain obligations designed to protect the petitioners' retained mineral interests. These obligations included the operation of two drilling rigs in each of the two known fields until there was one well for each twenty acres of producing land (R. 245-246); the reasonable development of those lands not included in the two fields in the event oil was discovered in paying quantities upon them (R. 247, 248); the drilling of five 10,000 foot test wells upon the petitioners' request, within certain of the areas involved, five years after the known fields had been developed to the minimum extent required (R. 248, 249, 251-253). Appropriate division orders were executed providing for the allocation of the oil produced to the several owners. (R. 256, 257).

In their income tax returns the petitioners reported the gain realized as gain from the sale or exchange of capital assets under Section 117 of the Revenue Act of 1938,[6] the gain being measured by the difference between the cost of the properties conveyed and the consideration received. (R. 258). The Commissioner held that the conveyance was a sale of the surface of the land but only a lease of the minerals therein, and that so much of the consideration as was allocable to the minerals conveyed should be treated as a lease bonus subject to the depletion allowance rather

---

[5] The mineral interests not conveyed were: 3/8 of all the oil produced and saved from those portions of the land which were included in the Friendswood and Clear Lake oil fields from a depth of not more than 7,500 feet; 1/4 of the oil produced and saved from the portion of the land which was not included in the same two fields and produced from a depth of not more than 7,500 feet; 3/16 of all oil produced from all the land from a depth of more than 7,500 feet (R. 253). The mineral interests not conveyed were reduced in cases where tracts which had been purchased by the petitioners subject to mineral interests retained by previous owners. (R. 243, 244.)

[6] It was stipulated that the lands and minerals sold were capital assets. (R. 30, 31.)

than as capital gain taxable at capital gain rates. (R. 259). The Tax Court sustained the Commissioner[7] (R. 275) and the Circuit Court of Appeals affirmed the Tax Court's decision.[8] (R. 337).

Neither the deed (Ex. 1, R. 36) nor the contemporaneous contract (Ex. 2, R. 92) contained any provisions for forfeiture, reversion, or any other terms limiting in any way the fee simple estate conveyed to Humble. The limited obligations assumed by Humble in no wise affected the title conveyed.

SPECIFICATION OF ERRORS TO BE URGED.

The Circuit Court of Appeals for the Fifth Circuit erred:

1. In determining that the transaction amounted to a lease of the minerals notwithstanding there was a sale of the surface of the land.

2. In affirming the holding of the Tax Court that the tax liability arising from the sale and conveyance of the minerals was not determined by the capital gain provisions of the Revenue Act.

3. In deciding that there was substantial evidence to support the holding of the Tax Court that the conveyance was a lease of the minerals.

4. In deciding, in substance, that the interpretation and effect given the conveyance by the Tax Court and the application thereto of Section 117 of the Revenue Act was binding upon the Circuit Court and not subject to review.

5. In holding, in effect, that the conclusion of the Tax Court as to whether the conveyance constituted a "sale" of the minerals within the meaning of Section 117 of the Revenue Act of 1938, was a finding of fact that was binding upon the Circuit Court on review.

6. In affirming the decision of the Tax Court.

---

[7] Two judges dissenting.

[8] One of the three judges dissenting.

REASONS FOR GRANTING THE WRIT.

I. The question involved is an important question of federal law which has not been, but should be, decided by this Court.

The immediate question involved has never been considered by this Court nor by any of the Circuit Courts of Appeals (except in the instant case) despite the fact that in Texas and other oil producing areas it is customary for landowners to retain a mineral interest when they sell their land.[9] This widespread practice has not hitherto led to tax litigation because it has been assumed by sellers, and apparently by the Commissioner, that sales of land were "sales" for tax purposes irrespective of the retention of a portion of an interest in the minerals (a royalty). Those who have made such sales in the past and those who may make such sales in the future do not now know (1) whether the sales are in no case to be treated as sales of capital assets; (2) whether they are to be treated as sales only if minimum development to the extent of that here present is contractually provided for; or (3) whether a lesser provision for development will carry with it similar tax results.[10]

In view of the large number of taxpayers affected and the widespread uncertainty created by the decision of the Circuit Court of Appeals, the basic question should authoritatively be answered by this Court.

---

[9] The reason for the growth of this custom is found in the impossibility of achieving a fair lump sum selling price for potential mineral producing land in the absence of any inexpensive and precise method of determining the probable mineral content of the area. Landowners, accordingly, seek to gain for themselves at least a portion of benefits of minerals which may be discovered by retaining a portion of them in the form of a royalty.

[10] The brief of Commissioner in the Circuit Court of Appeals in the case at bar argued that in any instance where the owner of minerals sells less than all the minerals the transaction is a lease and not a sale. (Commissioner's brief pp. 21, 22.) Moreover, the Commissioner's agents are, upon the authority of the decision of the Tax Court in this case, holding that where any mineral interest is retained by the vendor, with or without contractual covenants of development, the transaction is a lease and not a sale.

II. The decision of the Circuit Court of Appeals is in conflict with the principles laid down by this Court in related cases.

This Court has, in a number of cases, considered and delineated the tax consequences of certain types of relationships also commonly found in this industry between landlord and tenant, tenant and subtenant, and tenant and assignee.[11] In these cases this Court has allowed the statutory depletion deduction to those retaining the capital investment in minerals in place and has laid down the basic principles upon which cash payments, oil payments and royalties are to be treated as payments for capital assets or as the return for the exploitation of a retained mineral interest (i.e. rent) in varying circumstances. The principles laid down in these cases have not been followed by the Circuit Court of Appeals in its determination of the present case.

In *Burnet* v. *Harmel*[12] this Court stated that a bonus payment upon the execution of an oil lease is merely an advance royalty similar to advance rent and derives its character (whether a payment for a capital asset or ordinary income) from the nature of the transaction. The Court emphasized[13] that an oil *lease* was not a sale of oil and gas because the lessee acquired the privilege to exploit the land for only a "prescribed period" and because at the termination of the lease all unabstracted minerals would remain the property of the lessor. The Circuit Court held the cash payment here an advance royalty even though Humble acquired a fee and not the privilege of exploitation only for a "prescribed period" and even though there could be no termina-

---

[11] E. g. *Burnet* v. *Harmel*, 287 U. S. 103 (1932); *Palmer* v *Bender*, 287 U. S. 551 (1933); *Herring* v. *Commissioner*, 293 U. S. 322 (1935); *Thomas* v. *Perkins*, 301 U. S. 655 (1937); *Helvering* v. *Elbe Oil Development Co.*, 303 U. S. 372 (1938); and *Anderson* v. *Helvering*, 310 U. S. 404 (1940), the only case involving the transfer of a fee interest.

[12] *Supra*, p. 106.

[13] *Supra*, pp. 107, 111.

tion of the estate granted to Humble and there was no accompanying right of reversion of unabstracted minerals in the petitioners.

Subsequent cases have applied the basic concept in a variety of circumstances, but it has been unaltered.[14] In no case has a cash payment upon the transfer of a fee interest been held to be a bonus upon which the depletion allowance may be taken. All the decided cases indicate that such a payment is not subject to the depletion allowance, from which it follows that the payment is for the sale of the mineral interest. The decision of the Circuit Court of Appeals is, therefore, in conflict with the basic principles laid down by this Court in the cognate fields of depletion allowances and capital gains (or losses).

III. The decision of the Circuit Court is in conflict with principles laid down by the Ninth Circuit in related cases.

The Circuit Court of Appeals for the Ninth Circuit has decided two cases[15] in which was presented the closely related question whether certain transfers were outright transfers of mineral interests when the owner had purported to lease them, reserving a percentage of the net profits for the term of the lease. The Circuit Court of Appeals for the Ninth Circuit held that the landowner had not trans-

---

[14] Thus in *Palmer* v. *Bender*, *supra*, a cash payment upon the assignment (or sublease) of a lease by the lessee, who also retained a royalty for the duration of the lease, was considered an advance royalty. This royalty, like that in the *Harmel* case, was considered ordinary income rather than the proceeds of a sale because it was made to acquire the right to exploit the land for a prescribed period. See also *Herring* v. *Commissioner*, *supra*, p. 324. In *Anderson* v. *Helvering*, *supra*, p. 409, it is stated that cash bonus payments "when included in a royalty *lease*" (emphasis supplied) are given the same consequences as royalties. *Helvering* v. *Elbe Oil Land Co.*, *supra*, p. 376 makes it plain that payments received "from the sale of oil and gas properties themselves" are not subject to a depletion allowance.

[15] *Commissioner* v. *Felix Oil Co.*, 144 F. (2d) 276 (C. C. A. 9th, 1944); *Commissioner* v. *Crawford*, 148 F. (2d) 776 (C. C. A. 9th, 1945), certiorari granted October 8, 1945.

ferred outright the mineral interest notwithstanding the net profits reservation.[16] In reaching this conclusion in the *Felix Oil Company* case, which was followed in the *Crawford* case, the Circuit Court emphasized that the owners therein had retained reversionary rights, the right of forfeiture for breach of conditions, and the right, upon the termination of the lease, to accede to certain equipment placed upon the property by the lessee.

The Circuit Court of Appeals for the Ninth Circuit felt that these distinctive rights of ownership were determinative of the nature of the transaction and the character of the payments made thereunder even where, according to its reasoning, a portion of the economic interest retained by the lessor was measured with reference to net profits. The Commissioner contended in this Court[17] that it is the particular provision for payment, not the form of transfer, which is determinative of the proper tax treatment of the payments. Or, stated otherwise, the character of the interest which is actually transferred, as opposed to the form of the operative instrument, must necessarily determine the nature of the payments for tax purposes. This is the case in every other form of transaction.[18] In the *Kirby* and *Crawford* cases it may be determined that the lessors did or did not transfer their economic interest in the minerals attributable

---

[16] The majority of the Circuit Court of Appeals for the Fifth Circuit came to the opposite conclusion in *Commissioner* v. *Kirby Petroleum Co.*, 148 F. (2d) 80 (C. C. A. 5th, 1945), certiorari granted May 21, 1945, presumably partially, at least, upon the ground of conflict with *Commissioner* v. *Felix Oil Co.*, *supra*.

[17] Commissioner's brief in this Court in *Kirby Petroleum Co.* v. *Commissioner*, *supra*, p. 15.

[18] For example, in the transfer of non-mineral lands, if the interest transferred is the right to occupy the property for a term of years, the payments made, irrespective of what they are designated or of how they are measured, are considered rent. If the interest transferred is what would be called a fee, the payments are considered payments for a capital asset even though they may be made over a large number of years. Payments are neutral in themselves and take their character from the nature of the interests transferred in the transactions which generate the payments.

to the lessor's right to share in net profits for purposes of determining the depletion allowances.[19] But it is significant that the Circuit Courts of Appeals did not hold that and the Commissioner does not contend that the payments made under the profit sharing arrangement should be treated as capital gain upon the sale of a portion of minerals in place. Presumably this contention is not made and the Circuit Courts did not so hold because the payments measured by net profits still take their character from the generating transaction. This transaction was a transfer of the right to exploit the lands for a limited period of time and upon the termination or forfeiture of the lease, unmined minerals would revert to the lessors.[20] The interest transferred in the case at bar was not of this character but that permanent right of use and possession known as a fee.

The petitioners here retained none of the above listed distinctive rights of ownership. The holding of the Circuit Court of Appeals for the Fifth Circuit in the instant case that the petitioners had leased the mineral interest is accordingly in conflict with the principles laid down in closely related cases by the Circuit Court of Appeals for the Ninth Circuit.

---

[19] It is the Commissioner's position upon this point that the lessors retained no depletable interest because the right to share in profits does not constitute gross income from oil and gas property upon which the depletion deduction is allowed. (Commissioner's brief in *Kirby Petroleum Co.* v. *Commissioner*, *supra*, in this Court, pp. 26, 27.)

[20] If this is not the reason, the Commissioner is taking the position that there can never be a sale of a portion of a mineral interest. In other words, in any case in which the grantor of minerals retains an interest in a portion of the minerals his mere retention of an interest in a portion of the minerals has the effect of preventing sale of another portion of the minerals from being regarded as such. We cannot believe that this was ever intended by Congress or by this Court since it is well recognized that sales of a percentage interest in minerals are common transactions.

IV. The Circuit Court's decision is in conflict with this Court's decision in Trust u/w of Mary Lily (Flagler) Bingham v. Commissioner.

The Circuit Court appears to take the view that the Tax Court's conclusion that the transaction amounted to a lease of the minerals is a determination of "fact" which is binding upon the reviewing court. The determination of this so-called fact required the Tax Court to come to two legal conclusions: (1) to place a given transaction in one of two well-recognized legal categories, a lease or a sale; and (2) to decide that the transaction was not a "sale" within the meaning of Section 117 of the Revenue Act of 1938.[21] Such legal conclusions are clearly within the scope of proper judicial review of the Tax Court and any doubt which may have previously existed upon the subject[22] is considerably dissipated by *Trust u/w of Mary Lily (Flagler) Bingham* v. *Commissioner*.[23] The Tax Court here has announced a rule of general applicability and the facts upon which it is based fall short of the statutory requirement. Cf. *Powers* v. *Commissioner*.[24] The Circuit Court in holding that the Tax Court's determination that the minerals were leased was a

---

[21] To state the ultimate situation more accurately, the Tax Court came to only one legal conclusion, that the transaction did not amount to a "sale" as that term is ordinarily employed in the law for it is well established that the term "sale" in the Revenue Acts is to be given its usual meaning. *Burnet* v. *Harmel, supra; Fairbanks* v. *United States*, 306 U. S. 436 (1939).

[22] Cf. *Dobson* v. *Commissioner*, 320 U. S. 489 (1943), rehearing denied, 321 U. S. 231 (1944).

[23] 65 S. Ct. 1232, decided June 4, 1945.

[24] 312 U. S. 259 (1941). In this case the question involved was that of value, a question traditionally considered a question of fact. Upon review it was determined that the Board of Tax Appeals had employed an improper criterion in making its findings. The criterion to be used in determining the value of a given type of property is considered a rule of general applicability and a question of law even though the fixing of value is said to be a finding of fact.

"fact"[25] has failed to perform its duty to review questions of law as that duty has been defined by this Court in the *Bingham* case.

CONCLUSION.

For the foregoing reasons it is respectfully submitted that this petition for a writ of certariori should be granted.

RANDOLPH E. PAUL,
J. ARTHUR PLATT,
JAMES H. YEATMAN,
Counsel for the Petitioners.

---

[25] If this determination is a finding of fact, it is not supported by substantial evidence. The evidence consists principally of the deed and the contract and they lend no support to the view that the transaction was a lease of the minerals.

Nos. 667-670

(6)

DEC 15 1945
CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

WESLEY W. WEST, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

J. MARION WEST, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

ESTATE OF J. M. WEST, DECEASED, JAMES M. WEST, JR., ET AL., EXECUTORS, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

JESSIE GERTRUDE WEST, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI.

RANDOLPH E. PAUL,
J. ARTHUR PLATT,
JAMES H. YEATMAN,
Counsel for the Petitioners.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

INDEX.

	Page
OPINIONS OF THE COURTS BELOW	1
JURISDICTION	2
QUESTIONS PRESENTED	2
STATUTE INVOLVED	3
STATEMENT OF FACTS	4
ASSIGNMENT OF ERRORS	6
SUMMARY OF ARGUMENT	7
ARGUMENT:	
Point I. The economic effects of the transfer to Humble were those of a sale resulting in capital gain; they were not those of a lease resulting in ordinary income	8
Point II. The lack of any right of forfeiture or reverter is determinative of the nature of the transaction	12
Point III. A holding that a sale of land with a royalty retained amounts to a lease of the minerals will result in confusion and completely alters existing practices	16
Point IV. The Tax Court's determination that the transaction did not constitute a sale within the meaning of the capital gains provisions of the Revenue Act is not binding upon reviewing courts	17
CONCLUSION	18

CITATIONS.

CASES:

Amerada Petroleum Co. v. Doering, 93 F. (2d) 540	10
Badger Oil Co. v. Commissioner, 118 F. (2d) 791 (1941), certiorari denied 314 U. S. 634, rehearing denied 314 U. S. 712	9
Bingham, Trust u/w, v. Commissioner, 65 S. Ct. 1232	18
Burnet v. Harmel, 287 U. S. 103	8, 10, 11, 12, 13

Page

Burnet v. Logan, 283 U. S. 404 15
Canadian River Gas Co. v. Higgins, ——— F. (2d) ———, C. C. H. Standard Federal Tax Reporter, Par. 9450 15
Commissioner v. Crawford, 148 F. (2d) 776, certiorari granted Oct. 8, 1944 .....13, 14, 15
Commissioner v. Felix Oil Co., 144 F. (2d) 276.... 13
Commissioner v. Hopkinson, 126 F. (2d) 406..... 15
Commissioner v. Kirby Petroleum Co., 148 F. (2d) 80, certiorari granted May 21, 1944.....13, 14, 15
Danciger Oil & Refining Co. of Texas, et al v. Powell, et al, 154 S. W. (2d) 632 11
Freeman v. Magnolia Petroleum Co., 165 S. W. (2d) 111, rehearing denied October 26, 1942..... 10
Freeport Sulphur Co. v. American Sulphur Royalty Co., 6 S. W. (2d) 1039 11
Helvering v. Elbe Oil Land Development Co., 303 U. S. 372 8
A. B. Innis v. Commissioner, T. C. Dockets 2735, 2736, decided June 29, 1945, C. C. H. Dec. 14,667(M) 13
Loomis v. Gulf Oil Corp., 123 S. W. (2d) 501..... 11
Morgan v. Commissioner, 309 U. S. 78, opinion amended and rehearing denied 309 U. S. 626..... 11
Palmer v. Bender, 287 U. S. 551 8
Sauder v. Mid-Continent Petroleum Corp., 292 U. S. 272, rehearing denied 292 U. S. 613..... 10
Thomas v. Perkins, 301 U. S. 655 8
Williams Bar Dredging Co. v. Commissioner, T. C. Dockets 3284, 4074, decided June 30, 1945, C. C. H. Dec. 14,669(M) 13

STATUTES:

Revenue Act of 1938, c. 289, 52 Stat. 447; Sec. 117.. 3

MISCELLANEOUS:

Walker, Jr., The Nature of the Property Interests Created by an Oil and Gas Lease in Texas, 11 Texas Law Review, 401 (1933) 10

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

WESLEY W. WEST, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

J. MARION WEST, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

ESTATE OF J. M. WEST, DECEASED, JAMES M. WEST, JR., ET AL., EXECUTORS, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

JESSIE GERTRUDE WEST, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI.

OPINIONS OF THE COURTS BELOW.

The opinion of the Tax Court is found in 3 T.C. 431 (R. 236-275). The Commissioner prevailed upon the issue now in question. The opinion of the Circuit Court of Appeals

for the Fifth Circuit (R. 331-337) is reported in 150 F. (2d) 723. The Commissioner prevailed upon the issue now in question.[1]

JURISDICTION.

1. The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925, c. 229, 43 Stat. 936, 28 U.S.C. Section 347(a).

2. The date of the judgments of the Circuit Court of Appeals for the Fifth Circuit herein sought to be reviewed is July 24, 1945, (R. 344-346) and the petitioners' petition for rehearing, filed on September 8, 1945, (R. 349-353) pursuant to an order of the Circuit Court of Appeals dated August 3, 1945, extending the time for filing such petition until September 11, 1945, (R. 348) was denied on September 18, 1945, (R. 353, 354).

QUESTIONS PRESENTED.

1. Whether the conveyance of the petitioners' lands under a general warranty deed and contract of December 28, 1938, including portions of the minerals thereunder constituted a sale of capital assets within the meaning of Section 117 of the Revenue Act of 1938, or whether the transaction was a sale of the surface of the land and the mere leasing of the minerals.

2. Whether the Tax Court's conclusion concerning the legal effect of the transaction and its interpretation and application of Section 117 of the Revenue Act of 1938 is final and binding upon review.

---

[1] The proceedings involving the above entitled petitioners were consolidated in the Tax Court (R. 20), in the Circuit Court of Appeals (R. 324), and in this Court and only one record has been printed covering the consolidated cases *sub nom. Wesley W. West* v. *Commissioner of Internal Revenue*, pursuant to stipulation of counsel (R. 356).

STATUTE INVOLVED.

The Statute involved is Section 117 of the Revenue Act of 1938, c. 289, 52 Stat. 447.

"Sec. 117. CAPITAL GAINS AND LOSSES.

"(a) DEFINITIONS.—As used in this title—

* * * * *

"(4) LONG-TERM CAPITAL GAIN.—The term 'long-term capital gain' means gain from the sale or exchange of a capital asset held for more than 18 months, if and to the extent such gain is taken into account in computing net income;

* * * * *

"(b) PERCENTAGE TAKEN INTO ACCOUNT. —In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

* * * * *

"50 per centum if the capital asset has been held for more than 24 months.

"(c) ALTERNATIVE TAXES.—

"(1) IN CASE OF NET LONG-TERM CAPITAL GAIN.—If for any taxable year a taxpayer (other than a corporation) derives a net long-term capital gain, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 11 and 12, a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

"A partial tax shall first be computed upon the net income reduced by the amount of the net long-term capital gain, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be the partial tax plus 30 per centum of the net long-term capital gain."

STATEMENT OF FACTS.

In December, 1938, the petitioners, and a certain charitable foundation not here involved,[2] were, and had been for more than two years, the owners of approximately 23,000 acres of land in Texas. On December 28, 1938, this land, together with certain improvements thereon, was conveyed by a warranty deed to the Humble Oil & Refining Company (herein called "Humble"). In the same deed the grantors also conveyed all the minerals underlying a certain 70.67 acres (of which the petitioners retained the surface estate) and the two hundred acre tract and improvements constituting the homestead of J. M. West and Jessie Gertrude West. (R. 238, 239). A portion of the minerals underlying the lands, more fully described below, was excepted from the conveyance. (R. 240, 241). Humble paid the petitioners $7,967,145.24[3] for the property.

The mineral interest excepted from the conveyance was described more particularly in a contemporaneous agreement entered into by the petitioners and Humble which was incorporated into the deed by reference (R. 238) and amounted to various percentages depending upon the locality and depth.[4] In the interest of simplicity we will refer to the petitioners' and Humble's respective interests

---

[2] For purposes of convenience the grantors will be called "the petitioners" although the charitable foundation is not here involved and although J. M. West, one of the original grantors, is now dead.

[3] The total cash payment was $8,032,145.26 which included payments for the assignment of two leases upon other lands, which leases are not now in issue. It was stipulated below that $65,000 of the total payment should be allocated to the leases and the Tax Court made a finding in accordance with the stipulation (R. 257).

[4] 3/8 of the oil which might be produced from two portions of the land lying within two known oil fields from a depth of not more than 7500 feet; 1/4 of the oil produced from areas lying outside the two fields and from a depth not in excess of 7500 feet; 3/16 of the oil produced from all areas from a depth of more than 7500 feet; and other provisions with respect to dry gas, casing head gas, and other minerals (Ex. 2, R. 94, 95, 96 and R. 253).

in the minerals as 3/8 and 5/8. The contract provided that in the case of any of the portions of land conveyed by the petitioners subject to royalties retained by the petitioners' grantors,[5] the interest retained by the petitioners was to be reduced by that amount. (R. 243, 244).

The contract further included specific provisions for the development and operation of the petitioners' and Humble's jointly held mineral interests. Humble agreed to operate two drilling rigs in each of the two known fields until there was one well to each twenty acres, or to a greater extent if it were necessary to drill offset wells to prevent drainage. (R. 245, 246). It was provided that if oil should be discovered above or below the then existing horizons in the known fields or upon the unexplored areas, Humble would reasonably develop the same, and a standard for reasonable development was set forth. (R. 247, 248). Humble was not required to explore new horizons or the unprospected areas generally but the petitioners were given the right to request Humble to drill five test wells within cerain areas at any time after the expiration of five years after the development of the two known fields to the extent provided. (R. 248, 249, 250). The depth of the test wells was limited to 10,000 feet. (R. 252, 253). Neither the deed nor the contract contained any provision for the reversion of any part of the lands to the petitioners nor any provision for forfeiture, (R. 255), nor other limitations upon the estate conveyed to Humble.

In their respective income tax returns for 1938, the petitioners reported the profits deemed to have been realized upon the transaction with Humble as a long-term capital gain (gain from the sale of capital assets held more than

---

[5] There were included in this category 28 tracts or portions of the tracts numbered 16 (R. 41), 25 (R. 44), 30 (R. 47), 31 (R. 47), 37 (R. 49), 38 (R. 49), 40 (R. 50), 41 (R. 50), 46 (R. 52), 59 (R. 56), 61 (R. 57), 63 (R. 57), 66 (R. 58), 69 (R. 59), 70 (R. 59), 71 (R. 60), 79 (R. 62), 81 (R. 63), 87 (R. 65), 90 (R. 66), 92 (R. 67), 98 (R. 69), 106 (R. 72), 107 (R. 73), 111 (R. 75), 112 (R. 75), 115 (R. 76) and 119 (R. 78).

two years[6]). In determining the profit a portion of the cost was allocated to the 3/8 interest retained.[7] (R. 258). The Commissioner asserted deficiencies on the theory the transaction was a sale of the surface and a lease of the minerals and that so much of the cash received by the petitioners as could be allocated[8] to the minerals and oil improvements constituted a cash bonus upon a lease upon which a depletion deduction was allowable and not a payment for capital assets. The portion of the cash payment which was allocated to the sale of the surface estate was treated as a payment upon the sale of capital assets. (R. 258, 259). The Tax Court sustained the Commissioner (R. 275)[9] and the Circuit Court of Appeals affirmed the Tax Court's decision. (R. 337).[10]

ASSIGNMENT OF ERRORS.

The Circuit Court of Appeals for the Fifth Circuit erred:

1. In determining that the transaction amounted to a lease of the minerals notwithstanding there was a sale of the surface of the land.

2. In determining that the tax liability arising from the transaction was not determined by the capital gains provisions of the Revenue Act.

3. In holding that there was substantial evidence to support the view of the Tax Court that the transaction amounted to a lease of the minerals and a sale of the surface.

---

[6] It was stipulated that the land and minerals conveyed constituted capital assets (R. 30, 31).

[7] There is no dispute concerning the proper method of allocating cost between the minerals and the surface and the allocation of 5/8 of the mineral cost to the minerals transferred.

[8] No allocation of payments between surface and minerals was made by Humble and the petitioners. There is no dispute concerning the proper allocation for tax purposes if one is to be made. (R. 259.)

[9] Two judges dissenting. (R. 276-281.)

[10] One judge dissenting. (R. 337-344.)

4. In deciding, in substance, that the interpretation and effect given the conveyance by the Tax Court and the application thereto of Section 117 of the Revenue Act was binding upon the Circuit Court and not subject to review.

5. In holding, in effect, that the determination of the Tax Court that the transfer did not amount to a "sale" within the meaning of Section 117 of the Revenue Act of 1938 was a finding of fact that was binding upon the Circuit Court on review.

6. In affirming the decision of the Tax Court.

SUMMARY OF ARGUMENT.

The economic effects of the transfer in question were substantially the same as those which would have resulted if the transaction had been couched in terms of the sale of a portion of the underlying minerals. The Commissioner has recognized in the Tax Court that had this been the case, the transaction would be governed by the capital gains provisions. Depletion deductions are not properly allowable upon the proceeds of an outright transfer of mineral interests. Depletion allowances are granted to allow owners of mineral interests to recover their capital as it is depleted by production. The holding in these cases that the cash payment amounted to a bonus has the effect of allowing a depletion deduction upon a payment arising out of a transaction which differs materially in its economic consequences from a lease and which transaction results in an outright transfer of a 5/8 mineral interest. Depletion is accordingly allowed upon a payment which has no reference to present or future production of minerals in which the petitioners have retained an economic interest.

The tax treatment of a payment is determined with reference to the transaction giving rise to the payment. The payment here in question arises out of a transaction which had the outstanding characteristics of a sale in that it was a permanent transfer without any possibility of forfeiture or reversion. It should not, therefore, be treated as a bonus upon a lease.

It is a very common practice for landowners in oil producing areas to sell their property and retain a royalty. Such transactions have until now been considered capital transactions. A holding that a sale of land subject to a retained royalty amounts to a lease of the mineral interest will result in confusion and will have the effect of altering the existing practices with reference to the tax treatment of such transfers. Any such change will not necessarily benefit the revenue.

The Tax Court's determination that the transaction in question did not constitute a sale within the meaning of the capital gains provisions of the Revenue Act of 1938 is not binding upon appellate courts. The question is a clear-cut question of law which is open to review.

ARGUMENT.

I. The economic effects of the transfer to Humble were those of a sale resulting in capital gain; they were not those of a lease resulting in ordinary income.

The sale of oil and gas properties results in capital gain (or loss)[11] and the leasing of such properties for a cash bonus plus royalties results in ordinary income from which a depletion allowance is deductible.[12] The capital gain tax and the depletion allowance have quite different purposes; the capital gain tax is directed to the encouragement of alienation of property[13] by the owner, while the depletion allowance is intended to allow the owner of an economic interest in mineral producing property to regain his costs as production gradually reduces the value of his property.[14]

---

[11] Helvering v. Elbe Oil Land Development Co., 303 U. S. 372 (1938).

[12] *Burnet* v. *Harmel*, 287 U. S. 103 (1932).

[13] *Burnet* v. *Harmel*, *supra*, p. 106.

[14] *Thomas* v. *Perkins*, 301 U. S. 655 (1937); *Palmer* v. *Bender*, 287 U. S. 551, 557, 558 (1933). "The allowance for depletion is intended to return to the owners of the oil reserve the loss of their

The provision in the revenue acts for the allowance of a depletion deduction does not have the effect of converting for tax purposes all transactions in oil and gas properties into leases. One may sell such property in the ordinary way (the surface and the minerals), or one may sell the minerals only, or a fraction of the minerals,[15] and all are capital transactions in which cost is returned through purchase price and not gradually through the depletion allowance on production. The Commissioner explicitly admitted in the Tax Court (R. 261) that a sale of a part of the minerals in place[16] would be governed by the capital gains provisions. Neither the Tax Court nor the Circuit Court of Appeals have suggested any other view.

The sale of 5/8 of the minerals in place differs in no substantial way from the sale by the petitioners of all the minerals with the exception of 3/8. In both cases it would be contemplated by the parties that the minerals would ultimately be produced.[17] In both cases the joint owners would necessarily make some plan or provision for the working of their joint interests.[18] In both cases the joint owners each

---

capital which enters into the sale price of the oil produced. It deals with *income realized by production*. It has *no* application to *sales in whole or in part* of the capital investment, the oil reserve itself." *Badger Oil Co.* v. *Commissioner*, 118 F. (2d) 791, 793 (C. C. A. 5th (1941), certiorari denied 314 U. S. 634 (1941), rehearing denied 314 U. S. 712 (1941).

[15] It is well established that in Texas and elsewhere a landowner may sell the surface only, the mineral estate only or a portion of the mineral estate only. (R. 261.) This was recognized by the Tax Court (R. 265) and by the Circuit Court of Appeals. (R. 332.)

[16] Also a part or all of a royalty interest.

[17] A purchaser of a 5/8 of the minerals in place could have no other possible reason for making the purchase.

[18] If the purchaser of the partial mineral interest agrees as a part of the purchase price to carry on certain developmental work instead of paying a larger amount of cash, the transaction is still a sale. It may be that the 3/8 of the value of the work carried on by Humble each year is an additional payment of purchase price

could allow his property to lie undeveloped indefinitely without impairing any of his rights and in both cases the seller has irrevocably parted with a portion of his property and no termination or forfeiture will ever result in its return to him. This is made entirely clear if we consider what the situation would be if the property had been owned by a third party, X, and Humble had purchased 5/8 of the minerals from X and the petitioners had purchased 3/8. Humble and the petitioners then would ultimately have to agree upon some method of operating their joint interests. If Humble undertook the operation, it could not be said that the petitioners had leased 5/8 of the minerals to Humble. The fact that Humble's grantor was not X but the petitioners cannot alter the underlying theory.

The economic effects of a leasing arrangement are quite different from those described above. The lessee of mineral interests receives the right to exploit the land for only a limited period of time.[19] Any minerals left in the ground upon the termination of the lease belong entirely to the lessor.[20] If the lessee fails to carry on reasonable development and exploration activities, his lease would terminate and the unmined minerals revert to the lessor.[21]

---

resulting in capital gain. But that question is not here presented since the transaction took place at the end of 1938, the only year involved.

[19] *Burnet* v. *Harmel*, *supra*, p. 107.

[20] *Burnet* v. *Harmel*, *supra*, p. 111.

[21] This is true irrespective of any specific provision for exploration and development. A mineral lease is said to carry an implied covenant of development. *Sauder* v. *Mid-Continent Petroleum Corp.*, 292 U. S. 272 (1934), rehearing denied 292 U. S. 613 (1934), which was a suit for the cancellation of a mineral lease in Kansas upon that portion of leased land upon which the lessee had failed to carry out reasonable development; *Amerada Petroleum Co.* v. *Doering*, 93 F. (2d) 540 (C. C. A. 5th, 1937); A. W. Walker, Jr., The Nature of the Property Interests Created by an Oil and Gas Lease in Texas, 11 Texas Law Review, pp. 401, 402 (1933); *Freeman* v. *Magnolia Petroleum Co.*, 165 S. W. (2d) 111 (1942), rehearing denied Oct. 26, 1942. We know of no instance in which a

The respective rights[22] of Humble and the petitioners under this transaction were completely different from those existing in the lessee and the lessor of the ordinary oil and gas lease. Humble did not acquire the right to exploit the land for a *limited* length of time but *forever*. There is no possibility that unmined minerals will ever revert to the petitioners. Humble could, at the risk of a suit for damages, fail to carry out any development whatever, and there could be no termination or forfeiture of its right to do so in the future. Humble could engage in the stipulated develop-

---

general covenant of development and operation has been implied in the case of a transfer of a fee interest with a resultant forfeiture of or termination of the purchaser's estate upon a breach of such a covenant. The problem is considered generally in *Danciger Oil & Refining Co. of Texas, et al* v. *Powell, et al*, 154 S. W. (2d) 632, 137 Tex. 484 (1941); *Loomis* v. *Gulf Oil Corporation*, 123 S. W. (2d) 501 (Texas, 1938), rehearing denied Jan. 13, 1938. In the one case we know of in which there was a conveyance of a fee and any covenant was implied by the court, the implied covenant was an extremely limited one arising from the express stipulation of the parties themselves. The case involves the sale of sulphur lands and a part of the stipulated consideration for the sale was the erection of one sulphur plant. Several sulphur plants were erected, operated for awhile and then shut down. The court held that the parties must have contemplated the continued operation of *one* plant (not all the plants) and granted damages. There was no suggestion that there could be any forfeiture of any interest by the purchaser upon the failure to operate even the one plant. *Freeport Sulphur Co.* v. *American Sulphur Royalty Co.*, 6 S. W. (2d) 1039 (Texas, 1928).

[22] These rights are determined by local law. It is immaterial for tax purposes by what name local law designates the relationship of the parties (*Morgan* v. *Commissioner*, 309 U. S. 78 (1940), opinion amended and rehearing denied, 309 U. S. 626 (1940)), but the substantive property rights of the parties as fixed by local law are binding upon the Federal Courts for purposes of taxation (*Burnet* v. *Harmel*, *supra*). For example, it is immaterial that Texas law would designate Humble's interest as a "fee estate," but it is material if under Texas law the rights and duties of the parties to this transaction are in marked contrast to those of a lessor and lessee under the law of Texas and elsewhere.

ment work[23] and then cease further activities for as long as it wished without any suit for damages or any danger that it would lose its rights to continue development when it suited its purposes to do so. After completing the minimum stipulated development provisions, Humble could fail to explore the unexplored areas or the sands lying above or below the present producing horizons without risk of damages, forfeiture or termination. Humble in this transaction gained far greater rights than it would have acquired under a lease and the petitioners transferred all the important incidents of ownership which would be transferred on a sale.

II. The lack of any right of forfeiture or reverter is determinative of the nature of the transaction.

While this is a case of first impression upon the exact question presented, the principles of law upon which any decision must be based have frequently been considered in cases dealing with the closely related question whether taxpayers acquiring or retaining various interests in mineral property have retained a depletable interest. The basic theory was clearly developed in *Burnet* v. *Harmel*.[24] In that case this Court analogized the cash bonus paid upon the granting of a lease (with a royalty retained) to an unusually large rent in the first year of a lease, pointing out that its size did not alter its basic character as rent. The Court described the essential characteristics of a mineral lease which distinguishes it from a sale of minerals in place; (1) that the lessee acquires and makes payment for the "privilege of exploiting the land for the production of oil and gas for a prescribed period";[25] and (2) that all the

[23] Which fall far short of the development work which would be required under the covenant implied under the ordinary oil and gas lease as pointed out by Judge Disney. (R. 279.)

[24] *Supra.*

[25] *Burnet* v. *Harmel, supra*, pp. 107, 111.

minerals not abstracted, "will remain the property of the lessor upon termination of the lease."[26]

When the transaction possesses these two determinative characteristics, it is regarded as a lease and all payments, including the bonus payment, made are considered similar to rent, taxable as ordinary income.[27] When the transaction has neither of these characteristics, as in the present case, any payments made thereunder cannot be considered rental income upon which a depletion deduction is allowable. The depletion allowance is granted only upon the theory that the landowner has retained some sort of economic interest in the minerals which is being (or is to be) depleted by production. The petitioners have retained no economic interest in the property sold to Humble for which they received the cash payment here involved. As Humble produces oil, 5/8 of the oil produced belong to it and 3/8 belong to the petitioners; the petitioners suffer no depletion of their interest by reason of the production of Humble's 5/8, they receive everything they own and lose nothing because Humble takes its 5/8 interest; the treatment of the cash payment, which was and could have been made only for Humble's 5/8 interest, as a bonus upon which depletion is allowable rather than as the purchase price, has the effect of giving the petitioners a depletion allowance upon the 5/8 of the minerals in which they have no economic interest whatever.

In several recent cases in the Circuit Court of Appeals[28] and the Tax Court[29] (which involved leases in which the les-

---

[26] *Burnet* v. *Harmel*, p. 111.

[27] Because the lease is of a mineral property, the rent is subject to the depletion allowance.

[28] *Commissioner* v. *Felix Oil Co.*, 144 F. (2d) 276 (C. C. A. 9th, 1944); *Commissioner* v. *Kirby Petroleum Co.*, 148 F. (2d) 80 (C. C. A. 5th, 1945), certiorari granted May 21, 1944; *Commissioner* v. *Crawford*, 148 F. (2d) 776 (C. C. A. 9th, 1945), certiorari granted Oct. 8, 1944.

[29] *A. B. Innis* v. *Commissioner*, T. C. Dockets 2735, 2736, decided June 29, 1945, C. C. H. Dec. 14,667(M); and *Williams Bar Dredging Co.* v. *Commissioner*, T. C. Dockets 3284, 4074, decided June 30, 1945, C. C. H. Dec. 14,669(M).

sor stipulated for a percentage of the net proceeds of the operation of the property) the Commissioner has taken a position exactly contrary to his view here. He has urged in the Circuit Court of Appeals that in these cases there was an outright transfer of the mineral interest and that the lessors retained no economic interest in the minerals by reason of their right to share in the net profits of the lessees. The Tax Court and the Circuit Court of Appeals for the Ninth Circuit have held that payments under the net-profit type of transaction are to be treated as rental income upon which the depletion allowance is deductible. They have distinguished the leasing transactions involved in those cases from a complete transfer of a portion of the mineral interest upon the ground that the lessors retained an economic interest in all the minerals by reason of their retention of rights of reverter and forfeiture.[30] As pointed out above, the petitioners here have retained no economic interest in all the minerals. They can never under any circumstances regain or assert a right to the 5/8 of the minerals conveyed to Humble whether the minerals are produced or allowed to remain in the ground indefinitely. The petitioner's capital investment in these minerals is gone.

In the *Kirby* and *Crawford* cases, the Commissioner has urged that the lessors failed to retain an economic interest in the minerals in place measured by the net profits. He has sought to deny the lessors a depletion deduction upon their share of net profits upon the ground that net profits do not constitute gross income from the property upon which the depletion deduction is based.[31] The Commissioner has not, however, taken the position in these cases that the share

---

[30] The Circuit Court of Appeals for the Fifth Circuit came to the opposite conclusion, one judge dissenting in *Commissioner* v. *Kirby Petroleum Co., supra.* Certiorari was granted in this case, presumably because of the conflict with the decisions of the Circuit Court of Appeals for the Ninth Circuit.

[31] Commissioner's brief in this Court in *Kirby Petroleum Co.* v. *Commissioner,* p. 8, *et passim.*

of net profits constitute the proceeds of a sale[32] of capital assets since he treats these payments as ordinary income.[33] If these payments are ordinary income, it must only be so because they arise out of a transaction which does not have the characteristics of a sale. As pointed out by Judge Learned Hand[34] "... payment never of itself creates a tax. It becomes taxable only by virtue of the nexus of facts of which it is a part, and which constitutes the legal transaction. It is the transaction which determines the character of the tax: i.e., whether it is to be imposed upon income, or upon capital gain ..." The transactions involved in the *Kirby* and *Crawford* cases, unlike that here in question, bore the characteristics of leases because the transferors retained a right of forfeiture and a right of reverter in unmined minerals. Accordingly, the payments involved in the *Kirby* and *Crawford* cases might reasonably be taxed as ordinary income.

---

[32] A sale is none the less a sale under the revenue laws because the purchase price is paid in installments in an unlimited total amount and over an unlimited period of time. *Burnet* v. *Logan*, 283 U. S. 404 (1931); *Commissioner* v. *Hopkinson*, 126 F. (2d) 406 (C. C. A. 2d, 1942). In the first case the payments were for an unlimited period of time, no maximum amount was fixed and, they were measured by the ore mined by the purchaser. In the second case similar payments upon the sale of patents were measured by a certain sum upon each article manufactured under the transferred patents and a percentage of any payments received by the buyer from licensing the patents to others.

[33] Commissioner's brief in *Kirby Petroleum Co.* v. *Commissioner*, p. 25, *et seq.*

[34] In his dissenting opinion in *Canadian River Gas Co.* v. *Higgins*, ——— F. (2d) ——— (C. C. A. 2nd, 1945), decided November 9, 1945, not yet officially reported and found in Vol. IV, 1945 C. C. H. Standard Federal Tax Reporter, Par. 9450.

III. A holding that a sale of land with a royalty retained amounts to a lease of the minerals will result in confusion and completely alters existing practices.

The Commissioner may contend here, as he in effect contended in the Circuit Court of Appeals (Government's brief, in the Circuit Court of Appeals, p. 13), that there can never be a sale for purposes of the capital gains provisions if the seller sells less than the full mineral interest (i.e. retains a royalty). If this is the law, it represents a revolutionary change in what has been the understanding of myriad taxpayers in mineral producing areas. It is the customary practice in these areas for landowners to sell their land retaining a royalty interest.[35] These have been considered sales by them both under the local law and for purposes of computing their taxes. So far as we have been able to ascertain, the present case is the first instance in the history of the income tax that the Commissioner has taken the view that a sale of land subject to a retained royalty amounts to a lease.

If the present transaction is held to be a lease for tax purposes, many taxpayers will have computed their taxes incorrectly[36] and many claims for refund and deficiency assessments will unquestionably result. There is no clear general advantage to the revenue[37] in determining that

---

[35] The reason for this custom is the difficulty of achieving a price fair to buyer and seller when it is impossible to have any very accurate idea of the amount of minerals present, if any. The royalty device ameliorates the risks of both buyer and seller that too much or too little is being paid. The prevalence of this custom is illustrated by the fact that in this very transaction the land conveyed included 28 tracts of land which had been purchased by the petitioners subject to royalties retained by former owners. See footnote 5 above.

[36] Some will have overpaid, others will have underpaid.

[37] The advantage or disadvantage to the Government over a period of years will depend upon the rates applicable to capital gains and depletion, the size and structure of the income of buyers and sellers and a number of other factors.

sales with royalties retained are leases and such a determination is contrary to the basic theory underlying the depletion provisions and the cognate capital gains provisions. These two considerations would argue strongly against upsetting a practice of long-standing and introducing confusion into a field of the tax law where none has existed before.

IV. The Tax Court's determination that the transaction did not constitute a sale within the meaning of the capital gains provisions of the Revenue Act is not binding upon reviewing courts.

It is somewhat difficult to ascertain from a reading of the Circuit Court's opinion the extent to which it thought itself bound by the conclusion of the Tax Court that the transaction did not constitute a sale within the meaning of Section 117 of the Revenue Act of 1938. In the latter part of the opinion (R. 336, 337), however, emphasis is laid upon what the Circuit Court felt was a limitation upon its jurisdiction. It apparently took the view that the Tax Court's conclusion that the transaction did not amount to a sale was a factual determination of the sort not open to review except upon the ground of no substantial supporting evidence.[38]

The Tax Court in reaching this conclusion was not drawing factual inferences, the basic facts are undisputed. It was placing the transaction in one legal category rather than another by a consideration of the rights and duties of the parties. Furthermore, this orthodox judicial function was carried on by the Tax Court with reference to the words employed in the applicable revenue act. Its conclusion was not that there was no sale for purposes of the law of Texas

[38] If the determination were of such a factual character, there is here no substantial evidence to support the conclusion. The evidence, consisting principally of two documents, the deed and the contract, lends no support to the view that the transaction was a lease of the minerals.

or for any purpose but that there was no sale within the meaning of Section 117 of the Revenue Act of 1938. Such a determination involves a "clear cut" question of law, "decision of which by the Tax Court does not foreclose . . . appellate courts"[39] upon review.

The Circuit Court of Appeals accordingly misunderstood the limits upon its own jurisdiction when it treated the Tax Court's determination that there was no sale as one not subject to review upon appeal.

CONCLUSION.

In view of the foregoing, it is submitted that the petition for a writ of certiorari should be granted and the decision of the circuit Court of Appeals should be reversed.

RANDOLPH E. PAUL,
J. ARTHUR PLATT,
JAMES H. YEATMAN,
Counsel for the Petitioners.

---

[39] *Trust u/w Mary Lily (Flagler) Bingham* v. *Commissioner*, 65 S. Ct. 1232, 1235 (1945).

DEC 15 1945
CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945

No. 667- 670

WESLEY W. WEST, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

J. MARION WEST, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

ESTATE OF J. M. WEST, DECEASED, JAMES M. WEST, JR., ET AL., EXECUTORS, *Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

JESSIE GERTRUDE WEST, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

MOTION FOR LEAVE TO FILE STATEMENT IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI FILED BY PETITIONERS.

GROVER SELLERS,
Attorney General of the State of Texas;

WM. J. FANNING,
Asst. Atty. General of the State of Texas;

ROBERT W. KENNY,
Attorney General of the State of California.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945

No.

WESLEY W. WEST, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

J. MARION WEST, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

ESTATE OF J. M. WEST, DECEASED, JAMES M. WEST, JR., ET AL., EXECUTORS, *Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

JESSIE GERTRUDE WEST, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

MOTION FOR LEAVE TO FILE STATEMENT IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI FILED BY PETITIONERS.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

Now come Grover Sellers, Attorney General of the State of Texas, William J. Fanning, Assistant Attorney General of the State of Texas, and Robert W. Kenny, Attorney Gen-

eral of the State of California, and respectfully move for leave to file, as amici curiae, the following statement in support of the petitions for writs of certiorari in the above styled cases.

STATEMENT.

We are prompted to urge that this Court accept these cases for review by reason of the fact that the question involved is one of wide interest to the people of the States of Texas, California and other oil producing states. It is a common practice in both Texas and California, as well as in other oil producing states, for landowners when selling their land to reserve to themselves varying rights in the minerals, such as a royalty interest in oil and gas.[1] Heretofore, so far as we have been able to ascertain, such transactions have been treated by the federal taxing agencies as falling within the capital gains provision of the income tax law.

However, as a result of the decision in the present cases, owners of potential mineral producing land do not know whether the proceeds of sales made by them, with an interest retained, will be treated as ordinary income or capital gain. This doubt[2] has had the effect of deterring many persons from selling their lands. Until the uncertainty may be resolved, sales of land in oil producing states will be retarded. It is a matter of public policy that there should be no restriction upon the disposition of property. Once landowners know their rights, they may be governed accordingly; but until the rights are known, there will be the restriction mentioned.

The decision of the Circuit Court of Appeals in these cases is out of harmony with the pronouncements of our

---

1 Because either the presence of or amount of underlying oil or gas is unknown, few owners of land desire to part with all their mineral rights.

2 The uncertainties caused by the decision have been further increased by the interpretation placed upon it by the taxing authorities. We have been informed that in reliance upon these cases deficiencies are being proposed in instances in which sales have been made with a royalty retained and in connection with which no provision for the development of minerals has been made.

local courts which regard transactions of this type as sales, not leases. It is well recognized that while the taxation of rights and interests is governed by the federal law, these rights and interests are those created by local law.[3] Accordingly, the decision of the Circuit Court of Appeals, characterizing this transaction as a lease of the mineral estate, necessarily introduces confusion into prevailing local concepts of these rights and duties.

WHEREFORE, it is respectfully suggested that the petitions for writs of certiorari should be granted.

Copies of this statement have been made available to counsel for the Commissioner.

GROVER SELLERS,
Attorney General of the State of Texas;

WM. J. FANNING,
Asst. Atty. General of the State of Texas;

ROBERT W. KENNY,
Attorney General of the State of California.

---

3 *Morgan* v. *Commissioner*, 309 U. S. 78 (1940), opinion amended and rehearing denied, 309 U. S. 626 (1940).

INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statute involved	3
Statement	5
Argument	11
Conclusion	17

CITATIONS

Cases:

Anderson v. *Helvering*, 310 U. S. 404	12, 13
Bingham, Trust of v. *Commissioner*, 325 U. S. 365	16
Burnet v. *Harmel*, 287 U. S. 103	12, 13
Commissioner v. *Crawford*, 148 F. 2d 776	15
Commissioner v. *Felix Oil Co.*, 144 F. 2d 276	15
Kirby Petroleum Co. v. *Commissioner*, No. 56, this Term	15, 16
Palmer v. *Bender*, 287 U. S. 551	12, 13

Statutes:

Revenue Act of 1938, c. 289, 52 Stat. 447:

Sec. 22	3
Sec. 23	3
Sec. 117	4

Miscellaneous:

2 Summers, *The Law of Oil and Gas*, Sec. 284, *et seq.*	14

678677—46——1

In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 667

WESLEY W. WEST, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 668

J. MARION WEST, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

No. 669

ESTATE OF J. M. WEST, DECEASED, JAMES M. WEST, JR., ET AL., EXECUTORS, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

No. 670

JESSIE GERTRUDE WEST, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court and the dissenting opinions (R. 236–281) are reported in 3 T. C.

431. The opinion of the Circuit Court of Appeals, and the dissenting opinion of Judge Lee (R. 331–344) are reported in 150 F. 2d 723.

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on July 24, 1945 (R. 344–346). A petition for rehearing (R. 349–353) was filed on September 8, 1945, pursuant to an order of the Court granting an extension of time for the filing of the petition (R. 348). The petition for rehearing was denied on September 18, 1945 (R. 353–354). The petition for a writ of certiorari was filed on December 15, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

The taxpayer made a transfer of mineral interests in a transaction pursuant to which the transferee undertook defined obligations with respect to the development and exploitation of the lands, the taxpayer receiving from the transferee a cash sum and retaining a royalty.

The question presented is whether the Circuit Court of Appeals erred in affirming the decision of the Tax Court that the cash so received is not taxable under the capital gains provisions (Section 117) but is taxable as ordinary income

under Section 22 (a) and subject to depletion under Section 23 (m) of the Revenue Act of 1938.

STATUTE INVOLVED

Revenue Act of 1938, c. 289, 52 Stat. 447:

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case

in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. (For percentage depletion allowable under this subsection, see section 114 (b), (3) and (4).

* * * * *

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this title—

* * * * *

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held

for more than 18 months, if and to the extent such gain is taken into account in computing net income;

* * * * *

STATEMENT

This case involves the income tax liability of Wesley W. West for the calendar year 1938.[1] The facts as taken from the findings of the Tax Court and the stipulation of the parties (which was incorporated by the Tax Court as part of its findings (R. 259)), may be summarized as follows:

On December 28, 1938, the taxpayer, together with J. M. West, Jessie Gertrude West, J. Marion West, and the trustees of the West Foundation (hereinafter referred to as the Wests), transferred certain interests in lands situated in Texas to the Humble Oil and Refining Company, pursuant to a deed, assignment, and collateral agreement, all of which were executed simultaneously on that date (R. 30, 93, 238).

The deed covered some 23,155.60 acres of land (including a 200 acre homestead tract of J. M. West and wife, Jessie Gertrude West), together

[1] Proceedings determining the tax liabilities of Wesley W. West, J. Marion West, Estate of J. M. West, and Jessie Gertrude West, which arose out of the same transaction, were consolidated in the Tax Court (R. 236), in the Circuit Court of Appeals (R. 324–325), and in this Court (R. 356). For convenience, the Commissioner's brief in opposition will refer to only one taxpayer.

with the minerals only under 70.67 acres of other lands (R. 239). In the deed, the Wests "Granted, Bargained, Sold, and Conveyed" to Humble the described properties, "subject, however, to certain outstanding royalty interests, and to certain exceptions, terms, and provisions hereinafter referred to more specifically" (R. 36, 240).

Paragraphs A through G of the deed (R. 36–87) described the properties conveyed. Of these, paragraph G provided (R. 87):

> Also all oil, gas and other minerals produced from the land affected by this deed and produced subsequent to seven o'clock, A. M., December 28, 1938; subject, however, to the royalties hereinabove and hereinafter more specifically referred to, in so far as same apply to such oil, gas and/or other minerals.

The deed expressly excepted from the conveyance and retained to the grantors, their heirs, successors and assigns, certain royalties in accordance with the terms of the supplemental contract, which was expressly made a part of the deed for all purposes (R. 88).

The supplemental contract (R. 92–129) described the royalties excepted by the Wests and fixed upon Humble obligations with respect to exploitation and development. The royalties on oil ranged from $\frac{3}{16}$ to $\frac{3}{8}$, depending upon the depth from which it was produced and upon whether it was produced from the two known oil

fields on the land (the Friendswood oil field and the Clear Lake oil field) or from other portions of it. The royalties on gas were 1/6 on dry gas and 1/8 on casinghead gas, and that on other minerals was 3/16, except for sulphur upon which the royalty was $1.50 per long ton (R. 94–96). Section V of the agreement provided for the sale of the Wests' royalty oil to Humble at the prevailing market price, with an option in each of the Wests to terminate the purchase agreement as to his share at any time after five years (R. 106–108).

Humble's obligations to develop were defined in detail by Sections VII through X of the supplemental agreement (R. 109–117). It was required to operate at least two drilling rigs in the Friendswood and two in the Clear Lake oil fields until a producing well had been drilled for each twenty acres of the producing area, or to a greater density if necessary in order to offset wells drilled on other lands. In the event oil, gas, or other minerals were discovered in paying quantities on any portion of the land lying outside the two named oil fields (or in those fields at points below or above the existing production horizon) Humble was obligated reasonably to develop in those areas. It was further provided that after five years from the time when the Friendswood and Clear Lake oil fields had been developed to the described extent, the Wests could require Humble to drill one deep test well

678677—46——2

(limited to 10,000 feet) in each of five described areas.

Section XVIII of the agreement provided (R. 127–128):

> Humble is and shall be entitled to all oil, gas and other mineral produced from the property affected by said deed and assignment of even date herewith, produced subsequent to seven o'clock A. M., December 28th, 1938, subject to the royalties and overriding royalties hereinabove and in said deed and assignment specifically retained by First Parties. * * *

Section XIX provided for the arbitration of any disputed matter relating to the development of the properties, and Section XX provided that the terms and provisions of the contract were covenants running with the land (R. 128–129).

On December 28, 1938, Humble and the Wests executed a division order relating to one of the tracts involved to cover production above a depth of 7,500 feet. By this instrument, the parties certified and guaranteed that they were the sole owners of, and warranted title to, their respective interests in all oil produced (R. 256). The division order further provided that (R. 257):

> The oil run hereunder shall on the terms herein contained become the property of Humble Oil & Refining Company immediately upon being received into the possession of said Company. * * *

Similar division orders were executed by the parties covering oil and gas produced from other productive portions of the land conveyed to Humble (R. 257).

On December 28, 1938, there was on the land covered by the deed one oil well, one gas well and one well being drilled thereon (R. 256).

Prior to December 28, 1938, J. M. West got in touch with the president of Humble and told the latter that he wanted to sell the properties. Humble was interested in acquiring the right to develop and operate the lands for oil. Negotiations were handled for Humble by Barrow, its vice-president, and they continued over a period of several months. At various times Barrow tried to discuss with West the possibility of acquiring a lease instead of purchasing the surface in fee, but without success. The negotiations between West and Barrow culminated in the execution of the deed, the agreement and the assignment. Thereafter Humble leased back the surface of the lands and the residence to J. M. West for grazing and agricultural purposes for a period of five years at an annual rental of $16,000. This lease was renewed with a like rental with the residence excepted (R. 239–240).

Humble paid a cash sum for the interests which it acquired under the deed, assignment and supplemental contract and the parties have stipulated how much of the cash consideration was

allocable to the surface of the lands, and the improvements thereon, covered by the deed (R. 31–35, 257–259).

It is also agreed that all the properties referred to in the deed, together with the improvements thereon, had been held by the Wests for more than two years prior to December 28, 1938; and that the properties did not represent stock in trade or other property of a kind which would be included in the inventory if on hand at the close of the taxable year, or property held primarily for sale to customers in the ordinary course of trade or business, or property used in trade or business of a character which is subject to the allowance for depreciation, except for the improvements which were on the land at the time the transaction occurred (R. 30–31, 238).

In their returns for the year 1938, the Wests treated the transaction as effecting a sale to Humble of the mineral interests covered by the deed and reported a profit thereon as a long-term capital gain. The Commissioner ruled that the cash paid by Humble for the mineral interests was ordinary income subject to depletion and determined deficiencies accordingly (R. 258–259). The Tax Court sustained the Commissioner's determination (R. 236–275), Judges Murdock and Disney dissenting (R. 276–281). The Circuit

Court of Appeals, Judge Lee dissenting, affirmed the decision of the Tax Court (R. 331–344).

ARGUMENT

1. The decision below is correct in every respect and further review by this Court is not warranted. The Tax Court and the Circuit Court of Appeals each concluded that the transaction primarily looked to the exploitation of oil in whose production both the taxpayer and Humble had an interest (R. 273, 334), that the parties possessed the same fractional interest in the oil to be produced as would have been true if the conveyance had actually been cast in terms of a lease (R. 268, 333–334), that the form by which the conveyance was made did not constitute the sole or controlling factor (R. 272, 333–334), and that, whatever legal differences might ensue under local law on account of the fact that the exploitation rights were granted through the form of a sale rather than by a lease, those differences were not substantial enough to alter the tax consequences from those that would have followed if the transfer had actually been denominated a lease (R. 272–275, 333–336). Accordingly, it was decided that the cash payment received by the taxpayer did not represent proceeds from the sale of a capital asset which would be taxable as a capital gain, but that it was a cash bonus, paid as

advance royalties, and constituted ordinary income to the taxpayer which was subject to the allowance for depletion (R. 275, 334–336).

The decisions below embody the proper application of principles which have been established by this Court. In determining the tax consequences of the transaction, the courts below rightfully disregarded the form that the particular instrument of transfer took, or its effect, under state law, respecting title to the oil in place. *Burnet* v. *Harmel,* 287 U. S. 103; *Palmer* v. *Bender,* 287 U. S. 551; *Anderson* v. *Helvering,* 310 U. S. 404, 411. Under *Burnet* v. *Harmel, supra,* it is manifest that the cash payment received was ordinary income to the taxpayer regardless of the fact that Humble may have acquired legal title under local law to a fractional portion of the oil in place, and regardless of the formal attributes of the instrument by which that was accomplished.

The taxpayer seeks to avoid the application of *Burnet* v. *Harmel, supra,* by emphasizing certain alleged differences between an ordinary leasing agreement and the instruments involved here (Br. 8–13). However, even if such differences do exist, they are demonstrably immaterial. The fact that the taxpayer may not have retained a reversionary interest in the fractional portion of the oil granted to Humble has no controlling significance (Cf. Br. 10–13). The rule of *Burnet* v. *Harmel, supra,* was expressly followed in *Palmer* v. *Bender, supra,* where the Court rejected the

contention that, despite the retention of an interest in production, a cash payment constituted the proceeds of a sale because the taxpayer did not retain a reversionary interest under state law. Instead, the Court held that, irrespective of the absence of a reversionary interest, and without regard to the fact that a lessor-lessee relationship might be lacking, the receipt of a cash payment upon the transfer of an interest in production was not the proceeds from the sale of a capital asset if the transferor also retained a continuing interest in production. Although the instrument in that case took the form of an assignment of a lease, while here it is in terms of a sale which, allegedly, transferred title to a fractional portion of the underlying oil, the cases are not to be distinguished on that account. *Burnet* v. *Harmel, supra; Palmer* v. *Bender, supra*; *Anderson* v. *Helvering, supra.*

It is not significant, either (cf. Br. 10–12), that Humble's right to produce was not limited in time, as would be true in the case of an ordinary lessee, and that Humble may have acquired all of the extraction rights formerly possessed by the taxpayer in the fractional portion of the oil transferred. The decision in *Palmer* v. *Bender, supra,* demonstrates that the distinction urged has no material bearing on the problem for there, too, the transferee's rights extended as long as the transferor's, and the transferee acquired all the rights which the transferor formerly possessed in

the fractional interest conveyed. It is true that in that case, upon the expiration of the original lease, the rights of both the transferor and the transferee would terminate, while here the rights of both parties are indefinite; the important factor, however, is that in both cases the transferor has retained, by way of a royalty, a continuing fractional interest in production.

There are, moreover, no practical economic differences between a lease, with the retention of a royalty interest, and an assignment or sale, with the retention of a royalty interest. Cf. Br. 10–12. The usual lease extends for as long as oil and gas may be produced in paying quantities. See 2 Summers, *The Law of Oil and Gas,* Section 284, *et seq.* Thus, a lessee, as a practical matter, may extract all the underlying oil, or may continue to do so until extraction is no longer practicable or profitable. If it be true that, in this case, Humble has acquired the abstract right to continue extraction after the reserves have been exhausted or have become depleted beyond the point where production would no longer be feasible, and that in the case of a lease, the taxpayer would have retained the right to do so, the difference seems only theoretical. It should be only too apparent that where the decision must turn on the question of who has an economic interest in the underlying oil, the result should not depend upon the presence or absence of the right to extract

nonexistent deposits or the right to produce where production is no longer practicable.

It is submitted that if the court below had arrived at any other conclusion, its decision would have been an invitation to skillful conveyancers to discard the usual terms of a lease and to devise new forms to achieve desired tax results, without altering the material relationships that exist in the ordinary leasing agreement.

2. There is no conflict in decisions. While the taxpayer (Pet. 9–11) asserts that the present case is opposed, in principle, to the decisions of the Circuit Court of Appeals for the Ninth Circuit in *Commissioner* v. *Felix Oil Co.,* 144 F. 2d 276, and in *Commissioner* v. *Crawford,* 148 F. 2d 776 (pending in this Court, No. 197, along with *Kirby Petroleum Co.* v. *Commissioner,* No. 56, October Term, 1945), the issues and principles presented are altogether different. The problem presented in these cases is now before this Court, and the only issue in this Court, as in the circuit courts of appeals, is whether the net profit payments received by a lessor, who has also retained a royalty interest, constitute income from the production of oil and are depletable. Accordingly, even if this Court, in resolving the conflict between the *Crawford* and *Kirby* cases, *supra,* should agree with the Circuit Court of Appeals for the Ninth Circuit that the net profit payments are subject to the depletion allowance, it is difficult

to envisage how the decision could conflict with that of the court below.

There is, moreover, no warrant for the taxpayer's suggestion (Br. 14) that the Commissioner's position in the present case differs from that expressed in the net profit cases. The Commissioner contends that there has not been a sale of a capital asset in either situation. In the present case, there has been no sale because the cash payment received was in the nature of advance royalties which are taxable as ordinary income. In the net profit cases, the payments are not depletable because they do not constitute "gross income from the property", but, nevertheless, they are payments of ordinary income and there has been no sale of a capital asset. See Commissioner's brief in the *Kirby* case, *supra,* pages 25–27.

The taxpayer also contends (Pet. 12–13) that the decision below is opposed to *Trust of Bingham* v. *Commissioner,* 325 U. S. 365. The assertion of this conflict is made despite the taxpayer's frank admission that (Br. 17):

> It is somewhat difficult to ascertain from a reading of the Circuit Court's opinion the extent to which it thought itself bound by the conclusion of the Tax Court that the transaction did not constitute a sale within the meaning of Section 117 of the Revenue Act of 1938. * * *

Since the Circuit Court of Appeals referred to the *Bingham* case (R. 336), it is clear that it was

fully aware of the latest pronouncement of this Court respecting the extent to which the Tax Court's decisions must be accorded finality.

We believe that it is not necessary to discuss the finality of the Tax Court's conclusions in the present case. For, even if we should agree with the taxpayer that the question whether a sale occurred was not one on which the Tax Court was the final arbiter (Br. 17–18), the opinion below unmistakably shows that the Circuit Court of Appeals did not misunderstand the limits of its jurisdiction. The court clearly exercised its independent judgment in deciding that, under the statute and the applicable decisions of this Court, the taxpayer did not make a sale of a capital asset.

CONCLUSION

For the reasons expressed above, the petition for a writ of certiorari should be denied.

Respectfully submitted.

J. HOWARD MCGRATH,
Solicitor General.

SEWALL KEY,
A. F. PRESCOTT,
HILBERT P. ZARKY,
Special Assistants to the Attorney General.

JANUARY 1946.

U. S. GOVERNMENT PRINTING OFFICE: 1946

FEB 21 1946
CHARLES ELMORE CROPLEY

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

No. 667.

WESLEY W. WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 668.

J. MARION WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 669.

Estate of J. M. WEST, Deceased,
JAMES M. WEST, JR., et al., Executors, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 670.

JESSIE GERTRUDE WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION OF REHEARING UPON DENIAL OF A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

RANDOLPH E. PAUL,
J. ARTHUR PLATT,
JAMES H. YEATMAN,
Counsel for the Petitioners.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

No. 667.

WESLEY W. WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 668.

J. MARION WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 669.

Estate of J. M. WEST, Deceased,
JAMES M. WEST, JR., et al., Executors, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 670.

JESSIE GERTRUDE WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

PETITION OF REHEARING UPON DENIAL OF A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States.

The Petitioners, Wesley W. West, J. Marion West, Estate of J. M. West, Deceased, James M. West, Jr., et al., Executors, and Jessie Gertrude West, pray that this Court rehear and reconsider its denial of the petitioners' petition

for the issuance of a writ of certiorari to review the decision of the Circuit Court of Appeals for the Fifth Circuit in the above entitled consolidated cases. The order denying the granting of the petition was promulgated on January 28, 1946.

The history of the case, the questions presented, the statute and law involved, the specification of errors and the reasons for granting the writ are all set forth in the petition for certiorari and brief in support thereof, to which reference is made, and will not be repeated here.

Grounds for Granting the Petition.

This petition for rehearing of the denial of the petitioners' petition for a writ of certiorari is based upon the conflict in basic principles between this Court's decision in *Kirby Petroleum Co.* v. *Commissioner*[1] and *Commissioner* v. *Crawford*[2] and the decision of the Circuit Court of Appeals for the Fifth Circuit in the above entitled cases. That the application of these basic principles is properly considered a question of law is apparent from the decision in the *Kirby* and *Crawford* cases.

This Court in its decision in the *Kirby* and *Crawford* cases has again emphasized that, "The test of the right to depletion is whether the taxpayer has a capital investment in the oil in place which is necessarily reduced as the oil is extracted," and that economic interest means not title but "the possibility of profit from that economic interest dependent solely upon the extraction and sale of *the oil.*"[3] (Emphasis supplied). "The oil" from which the possibility of profit arises, the extraction of which reduces a taxpayer's capital investment, is the oil which is necessary

---

[1] U. S. , decided January 28, 1946, found in Vol. IV, C.C.H. Standard Federal Tax Reports, par. 9149.

[2] U. S. , decided January 28, 1946, found in Vol. IV, C.C.H. Standard Federal Tax Reports, par. 9149.

[3] Opinion of this Court in *Kirby Petroleum* v. *Commissioner, supra.*

for the payment of royalties as is made clear in footnote 6 of this Court's decision. If a taxpayer has retained no interest in oil other than the oil necessary for the payment of royalties, he has no depletable interest in the central reservoir of oil other than the amount of his royalty oil.

In the present case the taxpayers retained no interest in the property conveyed except their 3/8 interest in the minerals, and yet under the decision of the Circuit Court of Appeals they are considered as having a depletable interest in some portion of the 5/8 interest irrevocably conveyed to Humble, a depletion allowance having been necessarily permitted upon the cash received by the taxpayers in payment for the 5/8 interest conveyed to Humble if the transaction is treated as a lease of the minerals.

The Circuit Court's decision is not in accord with the test laid down by this Court that a taxpayer, to be entitled to a depletion allowance, must have a capital investment which is being depleted by production. As oil is produced, the petitioners obtain their full 3/8 interest in each barrel. The production of Humble's 5/8 interest depletes no interest of the petitioners. The failure to treat the transaction as an outright sale of 5/8 of the minerals results in giving the petitioners a depletion allowance upon the cash payment which is not attributable to any economic interest retained by them. On the other hand the decision of the Circuit Court does not give the petitioners the benefit of the capital gain rate which is applicable to a transaction in which a taxpayer has stripped himself of all economic interest.

This Court pointed out in the *Kirby* case that a lessor's possibility of a return of capital depends upon oil production and ends with the exhaustion of the supply. The petitioners' possibility of return of their capital investment in the 5/8 interest does not so depend or end. Any return of capital to these petitioners was ended definitely and for all time when the conveyance was made. They have given up forever any interest in the 5/8 interest irrespective of pro-

duction. Continued production or an indefinite ceasing of production has no effect upon the petitioners' capital investment in the 5/8 interest; it is neither returned by the former nor withheld by the latter. As this Court has reiterated in the *Kirby* case, where there is an "absolute sale," the seller receives a "sale price" and not ordinary income upon which is allowed the depletion deduction. There is an absolute sale when the former owner transfers property without retaining any interest in the property conveyed, here a 5/8 mineral interest.

CONCLUSION.

For the foregoing reasons it is urged that a rehearing be granted and the order denying the petitioners' petition for a writ of certiorari be reconsidered.

The undersigned, the counsel of record for the petitioners, certify that this petition for a rehearing is presented in good faith and not for purposes of delay.

Respectfully submitted,

RANDOLPH E. PAUL,
J. ARTHUR PLATT,
JAMES H. YEATMAN,
Counsel for the Petitioners.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945

No. 667

WESLEY W. WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

No. 668

J. MARION WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

No. 669

ESTATE OF J. M. WEST, DECEASED,
JAMES M. WEST, JR., ET AL., EXECUTORS, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

No. 670

JESSIE GERTRUDE WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

SECOND PETITION OF REHEARING UPON DENIAL OF A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

J. ARTHUR PLATT,
JAMES H. YEATMAN,
Counsel for the Petitioners

ALPHA LAW BRIEF CO., HOUSTON, TEXAS

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945

No. 667

WESLEY W. WEST, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

No. 668

J. MARION WEST, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

No. 669

ESTATE OF J. M. WEST, DECEASED,
JAMES M. WEST, JR., ET AL., EXECUTORS, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

No. 670

JESSIE GERTRUDE WEST, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

SECOND PETITION OF REHEARING UPON DENIAL OF A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

To the Honorable Chief Justice and Asssociate Justices of the Supreme Court of the United States:

The Petitioners, Wesley W. West, J. Marion West, Estate of J. M. West, Deceased, James M. West, Jr., et. al., Execu-

tors, and Jessie Gertrude West, pray that this Court rehear and reconsider its denial of the petitioners' petition for the issuance of a writ of certiorari to review the decision of the Circuit Court of Appeals for the Fifth Circuit in the above entitled consolidated cases. The order denying the granting of the petition was promulgated on January 28, 1946. A petition for rehearing was filed February 21, 1946 and denied February 25, 1946.

The history of the case, the questions presented, the statute and law involved, the specification of errors and the reasons for granting the writ are all set forth in the petition for certiorari and brief in support thereof, and in the first petition of rehearing, to which reference is made, and will not be repeated here.

Grounds for Granting the Petition

The Commissioner in his Supplemental Memorandum in BURTON-SUTTON OIL COMPANY, INC. v. COMMISSIONER OF INTERNAL REVENUE[1] urging the granting of a petition for certiorari in that case, states that if an assignment be considered as effectuating a sale of oil in place by the assignee, the decision of the Circuit Court of Appeals is correct. This decision denies to the assignee the right to exclude from its gross income the net profits payments due its transferror's assignor. If the case turns upon this point and if it is held that the assignee may not exclude the net profits payments to the assignor (from which it follows that the assignor has retained no depletable interest[2]) the differentiation between

[1] No. 361 in this Court, p. 5, certiorari granted February 11, 1946.

[2] Memorandum for the Respondent in **Burton-Sutton Oil Company, Inc., v. Commissioner of Internal Revenue,** No. 361 in this Court, p. 8.

a lease and an assignment can only be the reversionary interest retained by a lessor.[3] This basic point of distinction is also the point of distinction in the very closely related question whether a transaction is a sale or a lease involved in the above entitled cases. The above entitled cases should be considered along with the BURTON-SUTTON OIL COMPANY case since the same underlying legal theory may govern both.

If it is ultimately determined in the BURTON-SUTTON OIL COMPANY case that an assignee is not entitled to exclude the net profits payments from gross income, it can only be on the ground that the payments arise from an assignment, which amounts to a sale of oil in place[4], rather than a lease. In other words, by the assignment by which he retains only an interest in net profits, the assignor has retained no economic interest in the oil in place but has made an outright transfer. The only reasoning upon which an outright transfer can be grounded is that the assignor has not retained that right of reversion which is his continuing economic interest in oil in place which is being depleted by production. The Commissioner emphasizes[5] that it may be there was no true assignment (sale of oil in place) in the BURTON-SUTTON OIL COMPANY case because a right of reversion for failure to develop was contractually granted the assignor. This fact, in the Commissioner's view, gives the purported assignment the characteristics of a lease. We agree. In the case of the present petitioners no such reversionary interest was contractually or

---

[3] Supplemental Memorandum for the Respondent in **Burton-Sutton Oil Company, Inc., v. Commissioner of Internal Revenue, supra**, p. 5, footnote 2. The Commissioner is in error when he states that the right of reversion is of only theoretical importance. To oil operators and owners this right is of the greatest practical consequence.

[4] As in **Helvering v. Elbe Oil Land Co.**, 303 U.S. 372.

[5] Supplemental Memorandum, supra, p. 6.

otherwise retained in the minerals conveyed. The transaction accordingly lacked the outstanding characteristic of a lease. The same basic reasoning governs both the BURTON-SUTTON OIL COMPANY case and the above styled cases.

The Commissioner gives as a reason for granting the petition for a writ of certiorari in the BURTON-SUTTON OIL COMPANY case the importance of the issue in the administration of the revenue.[6] The issue in the above entitled cases is even more important. The custom of selling land with the retention of a royalty interest is much more widespread in oil producing areas than is the leasing or assigning of leases with the retention of an interest in net profits, either with or without the additional retention of an oil royalty. As previously emphasized, the decision of the Circuit Court and its varying interpretation by revenue agents have produced among sellers of oil land great confusion and uncertainty in respect to their tax liability and will unquestionably result in a large amount of litigation and controversy.

It is respectfully urged that a writ of certiorari be issued in the above entitled cases.

The undersigned counsel of record certify that this second petition for rehearing is presented in good faith and not for purposes of delay, all tax and interest asserted having been paid.

J. ARTHUR PLATT,
JAMES H. YEATMAN,
Counsel for the Petitioners

---

[6] Supplemental Memorandum, supra, p. 1.

Murphy J

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

No. 667

WESLEY W. WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 668

J. MARION WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 669

Estate of J. M. WEST, *Deceased*,
JAMES M. WEST, JR., et al., Executors, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 670

JESSIE GERTRUDE WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

I. Request for Permission to File a Third Petition for Rehearing Upon Denial of a Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

II. Motion for Rehearing Upon Denial of a Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

J. ARTHUR PLATT,
JAMES H. YEATMAN,
Counsel for the Petitioners.

PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1945.

No. 667

WESLEY W. WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 668

J. MARION WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 669

Estate of J. M. WEST, *Deceased*,
JAMES M. WEST, JR., et al., Executors, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

No. 670

JESSIE GERTRUDE WEST, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

I. Request for Permission to File a Third Petition for Rehearing Upon Denial of a Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

Now come the Petitioners, Wesley W. West, J. Marion West, Estate of J. M. West, Deceased, James M. West, Jr., et al., Executors, and Jessie Gertrude West, by their counsel

of record and request that this honorable Court grant its permission to the filing of the motion for rehearing set forth below.

II. Motion for Rehearing Upon Denial of a Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

The Petitioners, Wesley W. West, J. Marion West, Estate of J. M. West, Deceased, James M. West, Jr., et al., Executors, and Jessie Gertrude West, pray that this Court rehear and reconsider its denial of the Petitioners' petition for the issuance of a writ of certiorari to review the decision of the Circuit Court of Appeals for the Fifth Circuit in the above consolidated cases. The order denying the granting of the petition was promulgated on January 28, 1946. A petition for rehearing was filed February 21, 1946 and denied February 25, 1946. A second motion for rehearing was filed upon March 18, 1946 and was denied by an order dated May 6, 1946.

Grounds for Granting the Petition.

This Court should reconsider its decision and grant certiorari because the effect of the decision of the Circuit Court of Appeals for the Fifth Circuit is to subject capital to a non-proportional tax in violation of the XVI Amendment to the Constitution of the United States and in violation of the principles enunciated in *Eisner* v. *Macomber,* 252 U. S. 189 (1919).

The Circuit Court of Appeals has held that the purchase price received by a seller of land, who retains a royalty, is taxable as ordinary income subject only to the depletion deduction of 27½ percent. This result is reached by analogizing a sale with a royalty retained to a lease of oil lands upon which a cash bonus is paid. The depletion deduction, however, has no reference to the cost of the property. The seller has completely disposed of the property transferred and has no assurance that he will recover his cost.

To illustrate, if the cost of the lands here conveyed by the Petitioners had been $8,000,000 and they had received an $8,000,000 purchase price upon the conveyance, they would have realized no gain. Yet under the Circuit Court's decision they would be taxed upon $5,800,000 ($8,000,000 minus 27½ percent of $8,000,000) as ordinary income. If within a year of the sale the oil ran out, the taxpayers would never recover either their unrecovered investment of $5,800,000 or their land. This fact differentiates the seller's situation from the leasing arrangement where, if the oil ran out, the lessor would recover his property. A lessor would not, therefore, dispose of his property without recovering his cost and is not taxed upon capital when his lease bonus is taxed as ordinary income. A seller, however, under the principles laid down in this case is taxed upon his capital since he is not allowed first to recover his cost before the profit, if any, is subjected to tax. This result is in violation of the XVI Amendment and the revenue law should not be so interpreted.

It is respectfully urged that a writ of certiorari be issued in the above entitled cases.

The undersigned counsel of record certify that this third petition for rehearing is presented in good faith and not for purposes of delay, all tax and interest asserted having been paid.

J. Arthur Platt,
James H. Yeatman,
Counsel for the Petitioners.